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SUBJECT: MUNICIPAL HEATING SITUATION IN UKRAINE STILL CRITICAL

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11. (U) Summary: Many GOU agencies and international development organizations agree on the urgency of improving reliability and efficiency in the municipal heating and combined heat and power (CHP) sector, which accounts for about 16% of Ukraine's total natural gas consumption. Despite the clear need to modernize a sector where Soviet-era equipment is the rule, the GOU has long ignored this task, claiming it lacked the funds to take it on. End summary.

Alchevsk - Lessons Not Learned

12. (U) The most striking illustration of the problems of the Ukrainian heating sector was provided by the southeastern city of Alchevsk. In January 2006, Alchevsk experienced the worst heat supply system shortage in Ukraine since the breakup of the Soviet Union. The 2006 winter was one of the harshest in recent memory, as outdoor temperatures plunged to -35 C (-31 F). Due to multiple pipe breakages during the severe cold, 8 schools, 13 preschools, and apartment buildings that housed 67,000 people were cut off from heat. Many of the 120,000 inhabitants had to be relocated to other cities. It took more than a month to restore heat, and a thorough modernization has not yet been completed.

13. (U) The crisis in Alchevsk revealed several problems endemic in Ukraine:

-- The heating infrastructure was in a poor state of repair. Ukrainian energy experts stated the crisis could have been prevented, if the GOU had taken seriously warning signs that had been apparent for more than 15 years.

-- The centralized nature of the municipal heating system exacerbated the situation. Two, enormous, Soviet-built boilers serviced all of Alchevsk, and when access to both failed, it affected the entire city.

-- Local leaders were not prepared to respond to the crisis. Rather than seeking central government assistance, they hoped to resolve the situation on their own, and kept Kyiv uninformed.

-- Even once the Minister of Emergencies was involved, authorities were unable to restore heat without the help of an international relief effort, including a Russian-donated boiler.

14. (SBU) Although, the Alchevsk crisis triggered discussions on the

necessity of reforms in this sector, almost no tangible accomplishments have been achieved so far. The State 2007 Budget allocated 4 billion UAH for the communal services sector including district heating, but these funds will be made available to local budgets only on the condition of project co-financing and the introduction of energy-saving technologies in the housing and communal services arena. The mild 2006-2007 winter both lessened the GOU's sense of urgency and averted a repeat of the crisis. During a March, 2007, visit by a US Agency for International Development (USAID) multi-donor municipal heating modernization assessment team, several government officials and energy experts admitted that the next severe winter could easily produce another Alchevsk. They also conceded that there were no viable plans underway to address this risk.

Soviet-Era Heating Equipment and Housing

¶15. (U) The majority of Ukrainian municipalities receive heat from one or more Soviet-era heating systems. Due to high costs, only a few municipalities have tried to replace this obsolete equipment. Rather than replacing the old systems with new ones, other municipalities have attempted to repair and modernize the existing systems, sometimes by using substandard materials and equipment. (Note: In 2006, 1649 boilers throughout Ukraine were replaced, or about 5 % of the total number of boilers; 663 boilers were repaired or about 2%.) The first priority of all levels of Ukrainian government has been to keep utility rates low, rather than raise them in order to finance proper upkeep and replacement. Disappointed by unreliable services, some apartment building residents, especially those in smaller cities, have installed individual heating systems in their apartments. If the number of such cases grows, it may undermine the viability of municipal heating companies in the future. In fact, a few cities have completely replaced district heating with individual boilers and shut down their district heating facilities. The hard reality,

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however, is that few apartment buildings can be fitted with individual boilers, so for now the dependence upon municipal heating remains high.

¶16. (U) Ukraine's poor heating infrastructure is not only unreliable, but is also inefficient. Experts estimate that the 30 year-old and older rusted pipes, covered in tape, lose up to 30% of the heat they are meant to carry. Municipalities have tried to replace extremely worn-out pipes, but such replacements can take years due to lack of financing. Moreover, inadequate housing insulation and low-quality construction materials, coupled with almost no regular maintenance, compounded this inefficiency.

Uncertain Gas Prices

¶17. (SBU). Rising natural gas prices add urgency to Ukraine's need for improved energy efficiency in the heating sector, which depends on imported rather than domestically produced gas. Gas Ukraine's Head of Natural Gas Sales Department Yuri Kardash told us that 100% of the gas used to fuel district heating plants is imported. Ukraine currently pays \$130 per thousand cubic meters (tcm) for imported gas, and expects the price to increase to more than \$180 per tcm in 2008, according to Kardash. Although determined to keep this price low, Minister of Fuel and Energy Yuriy Boiko, noting that Poland currently pays \$300/tcm for imported gas, has acknowledged that Ukraine might only enjoy favored pricing over the short term.

Present Situation Offers No Solutions

¶18. (SBU) Local, regional, and national officials we spoke with in March agreed that the GOU lacked remedies for the problems of the heating sector. Local officials told us their budgets were

inadequate to fund major investments. National subsidies to local budgets were not targeted exclusively on energy investment and were, in any event, scarce and distributed unevenly from oblast to oblast.

(Comment: From our observations, the oblasts that were less dependent on central government budget subsidies seemed more likely to take the initiative in revising utility rates and implement reforms. Those which relied heavily on such subsidies appeared to be awaiting direction from the center. End Comment.)

¶9. (U) According to these officials, the district heating companies were not in a position to finance investment themselves; most were in poor financial condition. Many were in debt to the energy companies, just as their own customers were in arrears on their heating bills. Although many cities reached collection levels of 90-100% before the current winter, rate increases necessitated by the gas price spike resulted in collections as low as 30% in some cities, and even the best cities dropped to 70%. Nonpayment was accelerated this winter when some national political leaders challenged those cities with cost-recovery rates to justify the new rate levels, and told consumers not to pay their bills. As a result, some cities were compelled to roll back their rates to below-recovery levels. The issue became highly politicized, and the central government had not set a clear nationally unified rates policy.

¶10. (U) Some GOU entities, including local and oblast governments have sought help from donors such as the World Bank (WB) and the European Bank for Reconstruction and Development (EBRD). USAID has brought government officials and donors together, and itself has considered offering technical assistance to improving municipal energy efficiency. Donors' goals for Ukraine's heating sector include helping it become financially viable, adjust to rising gas prices, tackle the problem of debt within the system, and assist low income households in paying higher costs.

Metering and Energy Accountability

¶11. (U) The USAID assessment team noted that an effective way of improving energy efficiency would be the installation of proper metering and regulating systems for consumers of heat and other utilities. It would also require significant adjustments to the regulatory and legal framework for effective meter usage. Although all Ukrainian households are equipped with electricity meters, only 60% have gas meters, some have water meters and almost none have heat meters. EU Commission Energy Efficiency Project Manager for Ukraine, David Ceschia, pointed to Poland and Romania as examples of

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European nations which had benefited greatly through programs to improve metering. By forcing individuals to take fiscal responsibility for their own heat usage, the programs had significantly lowered overall consumption, he said.

¶12. (U) A few cities and oblasts have, however, actually taken steps on their own to increase energy efficiency. USAID assessment team leader, Ira Birnbaum noted that leaders in Ivano-Frankivsk oblast and the city of Lviv, both in western Ukraine, had supported the creation of condominium associations that transfer the responsibility for building maintenance and improvements to the owners instead of the municipalities. Leaders from these western areas have reported greater energy efficiency as condo owners took more responsibility for their buildings. Even though local leaders in Lviv have had some energy efficiency success, they acknowledged that they still have many areas to improve, and they also underlined the real urgency for implementing change in the municipal heating sector immediately.

Comment: Consensus, But Little Action

¶13. (SBU) Even though the GOU readily acknowledges the need to reform the municipal heating sector, signs of progress are few. To

try to address this long-term inactivity, USAID plans to encourage the formation of a regular roundtable of Ukrainian officials and international donors in order to begin implementing municipal heating development programs as soon as possible. Without multilevel governmental and legislative support from Ukraine for such international projects, it is doubtful that the current municipal heating sector could become reliable, let alone efficient.

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